

**MODERNIZING FINANCIAL
MANAGEMENT FOR
HUNGARIAN LOCAL
GOVERNMENTS**

**PILOT YEAR SEMINAR:
JANUARY 14, 1997**

Prepared for

Prepared by



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**MODERNIZING FINANCIAL MANAGEMENT FOR
HUNGARIAN LOCAL GOVERNMENTS
PILOT YEAR, JANUARY 14, 1997**

This report briefly describes the January seminar on modernizing financial management for Hungarian local governments. The January seminar was the fifth of six seminars which will be held throughout the Hungarian local budget cycle from June 1996 - March 1997. The program aims at providing financial officers of Hungarian local governments with skills and information to help them improve budgeting and financial management within their cities.

The one day seminar was held on January 14, 1997 at Hotel Rubin in Budapest. The agenda, list of participants, and course material handed out to participants are included in Annex A. Nine local governments attended the January seminar. Table 1 shows the list of local governments who have attended the five seminars held this far. The participating local governments represent a wide range of size and location, ranging from large cities such as Győr and Pécs and the smaller towns of Püspökladány and Orosháza.

I. January 14, 1997

The program started with an introduction and follow up of the last meeting by Mr. József Hegedüs from the Metropolitan Research Institute (MRI) in Budapest. Mr. Hegedüs stated that the December seminar had been limited to a day due to the budget preparation and work schedule of local governments. He thanked the participants for taking the time from their busy schedules to attend the seminar, and requested Mr. Philip Rosenberg (Urban Institute (UI) consultant) to introduce Mr. Edward A. Lehan (UI consultant) who was new to the program to the participants.

A. Presentation Skills for Budget Officers

Following the introduction, Mr. Lehan introduced and discussed the topic "Presentation Skills for Budget Officers." He stressed that effective communication on budgetary matters depends on:

- Penetrating knowledge of the subject.
- Thinking in terms of the subject, and
- Systematic application of proven techniques for organizing the expression of budgetary data.

Under subject matter knowledge, Mr. Lehan further discussed: 1) documentation criteria, which comprises problem definition and goals, collaborators and affected parties, condition of performance, work plan impact and benefits and alternatives and the budgets. 2) tracking expenditure variations from one year to the next. Mr. Lehan also provided examples illustrating the organization and display of budgetary data.

B. Exercise

In January or February of each year, local government finance officers present the proposed budget for the new year to the municipal council in their city. Training in this seminar therefore focused on a role playing exercise. Participants were divided into different groups—a 7 member municipal council, a clerk, a finance officer, and two technical department heads. The council had to appoint a mayor and was divided into two fractions: the majority and the opposition. The role playing simulation involved the finance officer presenting a budget to the council; comments by members of the public; objections and counter proposals on some budgetary elements by three council members; technical

explanations by two department heads, and a final vote on the budget by the council. The objective of the simulation was that finance officers should view the budget proposal from the perspective of the municipal council and thus be better prepared in defending their own budget.

C. Guest Speaker

The guest speaker in January was Mr. József Sivák, from the Prime Ministers office, department of administrative affairs. Following is a summary of his speech. Mr. Sivák discussed the government's proposed modernization plan for state budgets and administration. He stated that there are two kinds of operations in the department of administrative affairs: 1) central government operations, and 2) municipal operations.

Central Government Operations

Central government operations have currently been dealing with three issues:

- Organizational/institutional structural change. That is, should the individual ministries structure be made more uniform (last year several individual institutions were merged)?
- Pay scale of public administrators. Most ministries have 3—4 departments in which public administrators are given very low salaries and high administrative titles. The government is now attempting to raise the salary of public servants, since a large number would rather be department heads than state secretaries which enables them to take on several other jobs/positions.
- Deregulation/revision of the market.

Municipal Operations

The Prime Ministers office is starting a modernization of state budgets and administration. The two main issues of this program are:

- Structure of municipalities. Hungary has over 3000 municipalities some of which are very small and fragmented, with populations of approximately 300 individuals. This has negative economic repercussions on the economy.
- Responsibilities of municipalities. Four sub-issues were discussed here. 1) All local governments have the same legal standing and responsibility irrespective of their size. The central government is now aiming to restructure the tasks of small local governments, whereby their responsibility will be allocated to a higher level of government. The responsibilities of medium sized local governments is also under review. 2) The central government is considering the need for a middle level of government which will not restrict the freedom of the small local governments, but take on some of their responsibilities. 3) Local governments should create associations to undertake tasks which can be shared. The central government hopes to pass a law in March or April 1997 regarding the formation and regulation of municipal associations. The central government realizes that it cannot force local governments to form associations, and that it needs to provide incentives and funding for this purpose. 4) Local governments are highly dependent on central funds (especially if social security contributions are included). Local governments should increase their reliance on own revenues, which will give them greater autonomy and control. This should be a long run approach. Currently, local governments have the autonomy to



impose 5 local taxes that are not being exploited to the maximum. Local governments are hesitant to impose taxes that impact the citizens. They are more prone to use taxes which cause a burden on the business community. This should be changed. The central government is considering greater control over the personal income tax (PIT) by local governments, whereby local governments would be allowed to levy a part of PIT themselves.

D. Presentations by Local Governments of Draft Budgets

Mr. József Hegedüs and Ms. Ritu Nayyar-Stone were moderators for this section. Local governments were requested to limit their presentation to 10 minutes and use the following structure: state the sector which is the focus of program budgeting in their community and the "new" elements in the 1997 budget that have been incorporated from the topics covered in the *Modernizing Financial Management for Hungarian Local Governments* seminars; state the obstacles and problems preventing the city from making any changes and incorporating any of the above topics in the 1997 budget; state by when the city visualized being able to start program budgeting in the community; and finally, give reasons as to why these new changes will be adopted and accepted by the City Council. Following is the presentation by the local governments.

Szentes

The city's budget concept was accepted in November 1996. As of today the institutions' budgets are ready, and include new summarizing tables that comprise elements covered by the seminar. The city has included the program budget for city management in the 1997 budget. The sub-programs are road maintenance, public cleanliness and park maintenance. Program goals have been specified in each of these sub-programs as well as other programs. The final budget will be appropriated by mid-February.

A lot of time and effort was dedicated to the new budget. The technical committees were pleased with the new form of the budget, and willing to provide more budgetary details if required. The new budget was completed by the head of the finance department and her two colleagues, with help from other committees.

Püspökladány

This city has incorporated elements learned in the seminars in a general way throughout their 1997 budget. They plan to analyze and restructure the education sector into a program budget format for the 1998 budget. Currently, the new elements in the budget are the use of fiscal indicators (for example the cost to maintain one sq/m of pavement, cost of investment in roads, etc.); a more visual presentation of revenues with the use of diagrams; the breakdown of expenditures into operation and maintenance expenditures via pie charts, and an analysis and statement of resources available for financial investment.

The city would like to focus on the education sector in 1998 because the maximum revenues and expenditures are received by and assigned to this sector. This is also the least transparent sector and subject to constant changes both at the municipal and central level. The city would therefore like to

have evidence of funds available in this sector, and plans to use an external company to do a detailed financial analysis of the sector.

Győr

In May 1996, the Mayor instructed the finance department to prepare a budget preparation calendar with the schedule and responsibilities of different officials. Currently the draft budget has been prepared, and public hearings and fractional meetings have been held. The budget is now being marketed. On January 13, 1997 a meeting was held with city institutions and an agreement has been signed on budgetary cooperation subject to an increase in salaries.

The new elements in the budget are that Győr has prepared a forecast (CLF model) up to the year 2000 for the budget as a whole and also specifically in more detail for the housing sector. Housing investment and management has also been analyzed in the form of a program budget. However, Győr has had some resistance from different institutions and department heads who are not very receptive about program budgeting.

Hajdúszoboszló

The city has prepared budget guidelines for its institutions and used the sub-program of street lighting under city management as a area of focus for program budgeting. A forecast for revenues in 1997 has been prepared and fiscal indicators have also been included in the new budget. A small sub-program has been used so that it will be easy to implement program budgeting in this area.

In 1998, the city would like to analyze capital investment in street lighting. They would also like to prepare a program budget for sewage treatment plants, wastewater plants and the city spa.

Nagykanizsa

Nagykanizsa hired an external company in 1996 to analyze the different institutions. The result was a merger of some institutions, and the laying off of some employees. For the 1997 budget the city has developed and analyzed performance measures for its finance and health care departments. Fiscal indicators have also been developed.



E. Presentation of Financial Data to Bank Loan Officers

Following the above presentation by local governments, Mr. András Vigvári (Hungarian local trainer) from Budapest bank, discussed elements of loan application to the banking sector by local governments. Being a banker, he provided insight on the advantages and disadvantages of different borrowing techniques and the important terms of a loan contract. Mr. Vigvári also discussed the factors considered by banks while assessing the creditworthiness of local governments, and banks' underwriting considerations (predominantly local government budgets, and their annual report).

Mr. Vigvári informed the participants about loan availability from the European Bank for Reconstruction and Development (EBRD). Following are the loan conditions:

- All European Economic Community (EEC) local governments are eligible.
- Loans are available ranging from 20—70 million European Currency Unit (ECU).
- There exists a mandatory tender process.
- The goal of the institution is to fund a project which cannot be economically viable for the private sector, and a project which is of national importance.

Mr. Vigvári finally discussed elements which should be included by local governments in any loan application. They are:

- Amount of loan requested and the currency it is requested in.
- Purpose and economic aim of the project.
- Period of the loan and its financial justification.
- Collateral offered.
- Schedule of draw downs.
- Impact of borrowing on municipal financial management.

II. Background Reading

The binder handed out to participants included background or additional reading on the topics covered during the seminar. These were provided so that participants would have access to more detailed and specific issues related to the topics covered.

III. Local Government Homework

Since the last seminar (of the pilot year) in March is going to deal with issues regarding program monitoring and the relevance of, and need to adapt accounting practices to program budgeting, two simple questions were asked to local governments regarding the above. The homework has to be mailed in to MRI by all participants by February 14.

IV. Conclusions

Given the tight schedule of local governments in completing their draft budget for 1997, four local government representatives left the seminar after the speech of the guest speaker. This once again confirmed the notion that the program for 1997 should start in May; 5 seminars should be completed by December 1997, and the final concluding seminar should be held at the end of February 1998.

The agenda for the next seminar on March 13, 1997 was drafted at Hotel Rubin immediately following the conclusion of the seminar. The meeting was attended by the following MRI staff, local Hungarian trainers and Urban Institute staff. From MRI—Mr. József Hegedüs, Ms. Judit Kálmán and Ms. Andrea Tönkö. The Hungarian trainers included Ms. Katalin Pallai, and Mr. András Vigvári. The UI staff included Ms. Ritu Nayyar-Stone and Ms. Margaret Tabler, and UI consultants Mr. Philip Rosenberg and Mr. Edward A. Lehan.



Table 1

List of Cities Participating in the Pilot Year Seminars on Modernizing Financial Management for Hungarian Local Governments

No.	Cities	Population	June 27, 1996	September 12-13, 1996	October 30 - 31, 1996	December 5 - 6, 1996	January 14, 1997
.	Baja	39,800	✓	✓	✓	✓	✓
.	Budapest District VIII	40,042		✓	✓		
.	Budapest District XIX	78,400	✓	✓	✓		
.	Debrecen	24,900	✓	✓	✓	✓	
.	Derecske	9,500	✓				
.	Dunavarsány	5,201		✓			
.	Eger	61,400	✓				
.	Gyor	131,100		✓	✓	✓	✓
.	Hajdúszoboszló	23,387			✓	✓	✓
.	Jászládány	6,100	✓	✓			✓
.	Kistelek	7,900	✓				
.	Nagykanizsa	53,353			✓		✓
.	Orosháza	34,600	✓	✓	✓	✓	✓
.	Pécs	167,400	✓	✓	✓	✓	
.	Püspökladány	17,000	✓	✓	✓	✓	✓
.	Szentes	33,000	✓	✓	✓	✓	✓
.	Szombathely	85,200	✓	✓			
.	Szolnok	81,500	✓	✓	✓	✓	✓
.	Zalaegerszeg	62,485		✓		✓	

ANNEX A

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Agenda

List of Participants

A. Transparencies

A.1 Presentation Skills for Budget Officers

A.2 Budget Adoption Requirements

A.3 Issues of Municipal Borrowing

B. Exercise

B.1 Budget Adoption Simulation exercise

C. Background Reading

C.1 “Budget Formulation” by Edward Lehan

C.2 “Tips for an Oral Presentation of a Budget” by Philip Rosenberg

C.3 “The Budget as Literature” by Edward Lehan

C.4 “About the Creditworthiness of Local Governments” by András Vígvári

D. Local Government Homework

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Agenda
MODERNIZING FINANCIAL MANAGEMENT
FOR HUNGARIAN LOCAL GOVERNMENTS

January 14, 1997, Budapest
Hotel Rubin, 1118 Budapest, Dayka Gábor u. 3

January 14, 1997

9.00 - 9.30 a.m.	Registration
9.30 - 9.35 a.m.	Introduction and Follow-up from Last Meeting <i>József Hegedüs, Városkutatás</i>
9.35 - 10.05 a.m.	Presentation Skills for Budget Officers <i>Edward Lehan, The Urban Institute</i>
10.05 - 11.35 a.m.	Role Playing Exercise: Budget Presentation to City Council Moderator: <i>Edward Lehan, The Urban Institute</i>
11.35- 11.45	Coffee Break
11.45 - 12.30	Guest Speaker József Sívák , <i>Prime Minister's Office</i>
12.30 - 1.30 p.m.	Hosted Luncheon
1.30 - 4.00 p.m.	Presentations by Local Governments of Draft Budgets Moderators: <i>Ritu Nayyar-Stone, The Urban Institute, and József Hegedüs, Városkutatás</i>
4.00 - 4.15 p.m.	Coffee Break
4.15 - 5.45 p.m.	Presentation of Financial Data to Bank Loan Officers <i>András Vígvári, Budapest Bank, and Andrea Tönkö, Városkutatás</i> Moderator: <i>József Hegedüs, Városkutatás</i>
5.45 - 6.00 p.m.	Work assignment for participants <i>Philip Rosenberg, The Urban Institute</i>
6.00 p.m.	Adjourn

Issues of Municipal Borrowing

- The role of loans in municipal financial management
- The current borrowing regulations
- Advantages and disadvantages of the various borrowing techniques
- The borrowing technique selected depends on
 - the nature of the project financed (term and schedule of financing, the cash flow produced by the project, etc.)
 - a comparison of the present values of the **total** costs of funds (in theory the best techniques is the one that has the lowest present value)

Comparison of Various Borrowing Techniques

	Time needed for getting the funds	Term	Advantages	Disadvantages
1. Bond issuance, open, domestic	immediately	max. 5 years	The principal repayment and interest payment can be more flexible. There is no spread imposed by a bank. For good investment purposes, citizens can be involved in bond purchasing.	There are limited funds that can be involved. It is relatively costly to organise the issuance; there is a lack of expertise; there is a bad image to it domestically.
2. Bond issuance, private placement, domestic	immediately	max. 5 years	More flexible than bank loans.	There are limited funds that can be involved.
3. International bond issuance	immediately	may be over 5 years	The principal repayment and interest payment can be more flexible. More funds can be involved.	Exchange rate risk. The conditions depend on the country's credit rating. It is only worth when large amount of funds is involved.
4. Bank loan from domestic banks	in tranches, conditional	max. 5 years	The underwriting by the bank represents a preliminary and continuous control. The funds cannot be used for any other purposes through a political decision.	Funds of domestic banks. Cumbersome underwriting, strict conditions. For foreign currency loans, exchange rate risk.
5. Syndicated loans	in tranches, conditional	may be over 5 years	More funds can be involved. The underwriting process represents control.	Organising the syndicate is costly and lengthy.
6. Funds from international credit institutions	in tranches, conditional	may be over 5 years	For preferred purposes, relatively low interest rates. The thorough underwriting process represents a good control.	Mandatory international tendering, advisory fees, other production costs. Possibly exchange rate risk.

The Most Important Terms of Loan Contracts

- Interest basis, risk premium
- Dates
- Credit facility
- The beneficiary of the draw-down
- Conditions to termination
- Fees
- Special conditions to the first draw-down
- Conditions to subsequent draw-downs
- The most important (positive and negative) obligations of the borrower
- Events of default
- Collateral

Assessing Municipal Creditworthiness

—The most important document of municipal financial management is the *budget*. The **existence** and **quality** of the budget is crucial for assessing creditworthiness.

—When assessing creditworthiness, banks consider **quantitative** and **qualitative** aspects.

- **Quantitative indicators** e.g. - ability to pay,
 - debt servicing indicator,
 - degree of indebtedness,
 - proportion of central funds in the income,
 - net operating income proportion.

- **Qualitative indicators** e.g. - whether the community has a long-term concept,
 - quality of assets registered,
 - trends in changes in assets,
 - the tax policy of the municipality
 - the rating of how the community is managed
 - any negative statement in the course of

Basis of Collection data sheet

Survey, other information
source

the inspection by the State Audit Office

- whether the community has met its payment obligations
- the general economic conditions of the community and the region,
- the classification of the municipality (e.g., village, town, city, county)

Banks' Underwriting Considerations

1. The bank uses other people's money for onlending, not its own funds.
2. The bank will filter out the risks that are unmanageable/unacceptable to it.
3. For manageable risks, the bank will establish a risk premium (spread) for the loan.
4. In order to achieve the above objectives, the bank endeavours to learn all important features of the client/project and check any data supplied for validity and consistency.

AVERAGE CITY PROPOSED SECTORAL BUDGET

SECTORAL FUNCTIONS (000)

	LAST YEAR	THIS YEAR	PROPOSED BUDGET
CITY MANAGEMENT	217829	223420	254816
HEALTH SERVICE	2949	2079	2908
SOCIAL	266071	320202	210500
EDUCATION	1228		1750
CULTURE	4563	2747	16850
EXTERNAL ORGANIZATIONS	34601	48945	33520
SPORT	876	1034	15780
TOTAL	528117	598427	536124

REVENUE ANALYSIS (000)

	LAST YEAR	THIS YEAR	PROPOSED BUDGET
OWN REVENUES	306	156	2000
ACCUMULATIONS & CAPITAL INCOME		20	

FUNDS TAKEN OVER	3933	3801	
BUDGET TRANSFERS	523878	594450	534124
TOTAL REVENUE	528117	598427	536124

EXPENDITURE ANALYSIS (000)

	LAST YEAR	THIS YEAR	PROPOSED BUDGET
PERSONNEL	7401	6818	10140
TAXES FROM EMPLOYEES	2842	2765	4602
LOGISTIC EXPENSES	239153	246285	277362
TRANSFERS & SUBSIDIES	278721	342559	244020
ACCUMULATED EXPENSES			
OTHER			
TOTAL EXPENDITURES	528117	598427	536124

To: Municipal Council
From: Chief Financial Officer
Subject: Revised Revenue Projection

We previously submitted a budget for Sectoral Functions totaling HUF 536,124,000, supported by Own Revenues of HUF 2,000,000 and Budget Transfers of HUF 534,124,000.

This advises you that the total revenue expected from Budget Transfers is less than originally anticipated. In adjusting to this new estimate, we suggest that the Municipal Council consider reducing the commitment to Sectoral Functions from HUF 536,124,000 to HUF 500,000,000.

The Municipal Council may respond by either (1) increasing our reliance on user fees, the business tax, and other municipal revenues to meet our original expenditure plan of HUF 536,124,000; (2) reducing program commitments to HUF 500,000,000; or (3) a combination of revenue and expenditure changes amounting to HUF 36,124,000.

To: Municipal Council
From: Councilor Kiss
Subject: Increased Allocations for Improved Street Services

As we all know, there is a steady deterioration of our municipal streets. Citizen complain constantly to me about this situation. I am sure they complain to you, my colleagues on the council.

I have reviewed the proposed budget for next fiscal year and, with due respect to the judgment of the Mayor and his staff, we should increase the allocation to City Management to correct this situation. My analysis shows that, when adjusted for inflation, the city intends to reduce spending in this area by approximately 50%, when compared to the prior year expenditure of HUF 59,150,000.

My request for increased funding for City Management centers on the allocation for Street and Bridge Maintenance. This area has been reduced sharply in the proposed budget from HUF 51,991,000 in the current year to HUF 35,000,000 in the proposed budget year.

Using the prior year's budget of HUF 59,150,000 as a base, and adjusting for inflation at 30% per annum, we should spend HUF 100,000,000 in the proposed budget year simply to maintain the same level of spending as the prior year. Given the poor condition of the roads, we should provide this amount for pot-hole patching and rehabilitation of streets in serious disrepair.

To: Municipal Council
From: Councilor Nagy
Subject: Budget Reductions

I am incensed over the proposed budget for the next fiscal year. The three budget options suggested by the Chief Financial Officer in his memorandum to the Council do not go far enough to address the fundamental issue of our need to reduce expenditures significantly.

We need to make major cuts in all sectors of the budget, improve our productivity, reduce the number of municipal employees, and consolidate a number of institutions.

The savings to the city from these actions must be passed on to our citizens in the form of reduced taxes. A number of my colleagues on the Council support me in this request and we are prepared to withhold our approval of the budget until our demands are met.

To: Municipal Council
From: Councilor Pesta
Subject: Increased Allocations for an Expansion of Cultural Activities

I have reviewed the budget for the Sectoral Function. While the proposed budget increases the amount for Culture significantly, in recognition of the celebration of our thousand year anniversary, I think we should seriously consider increasing the allocation for Culture even higher than proposed.

We should capitalize on the opportunities our celebration brings to the city. I would like to add an additional HUF 5,000,000 to the proposed budget to fund activities featuring national and international performers. Currently, our cultural activities rely on local talent. Expanding cultural activities will further stimulate civic pride and generate increased economic activity by bringing visitors to the city. I believe the Economic Director can determine the economic benefit accruing to the city by expanding cultural activities.

HOMEWORK

- Define your strategy to monitor the programs you have identified in your program budget (e.g., financial and non-financial data). For example, will work plans be established for each activity? Will there be periodic formal reviews on actual results versus plan?

2. Define the changes needed within the accounting system to make it responsive to your program budgeting informational needs. For example, will you require flexible account coding, the use of subsidiary ledgers, etc.